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No. 91-552

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1991

RONALD COLEMAN, NANCY COLEMAN, HARVEY COLEMAN, CAROL COLEMAN, WILLIAM COLEMAN AND ARLETTE COLEMAN,

*Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

# *REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI*

Leon C. Baker
Attorney for Petitioners
81 Main Street
White Plains, NY 10601
(914) 997-7340

Of Counsel:
Arthur R. Miller
Langdell Hall
1545 Massachusetts Ave.
Cambridge, Massachusetts 02138

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Respondent's strategy in his brief in opposition to the petition for a writ of certiorari is to trivialize this case in order to make it appear unworthy of certiorari. In pursuance of that strategy, respondent has avoided

reference to the important tax law issue which is the basis for this petition, on which various courts of appeal have rendered conflicting decisions.

That tax issue -- which is far from trivial -- is whether the tax consequences of a transaction are to be determined by its economic substance or by its legal form. Respondent's position is that looking through the form of a transaction to its economic substance is an option reserved exclusively to the Internal Revenue Service ("IRS").

Respondent's contenttion is that taxpayers have no right to show that the form of a transaction has no practical economic significance and to pay taxes on the basis of the economic substance. His position is that a taxpayer may disregard form, even when form is without economic consequences, only with the consent of the IRS, which the IRS may grant or deny in its absolute discretion (depending on whether consent or denial will produce the greater tax).

The Third Circuit Court of Appeals has endorsed respondent's contention -- in spades. In the present case the form, a lease with an option to purchase for nominal

consideration, is for commercial law purposes only a security arrangement. Under the Uniform Commercial Code, the nominal "lessor," is only a secured creditor. Yet respondent and the Third Circuit declare (1) that for tax purposes the "lessor" is presumed to be the actual owner and (2) the "lessees" with an option to acquire title for nominal consideration at the end of the "lease" must show by "strong proof" that they really are what commercial law declares them to be -- the actual owners of the property subject to a secured indebtedness.

Moreover, the Third Circuit adds, the proof must be of a nature which would not be barred by the parol evidence rule or the statute of frauds in an action between the "lessor" and the "lessee". The lessee must show that there was fraud, mutual mistake, undue influence, duress or a scrivener's error. *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967) *cert. den.*, 389 U.S. 858 (1967).

Other circuit courts of appeal have not agreed that form of a transaction is to be determinative of the income tax to be paid. The Internal Revenue Code imposes tax, other circuits have held, not on the basis of

appearances but on the basis of the actual economic results, e.g. *J.M. Turner v. Commissioner*, 247 F.2d 370 (4th Cir. 1957) and other cases cited at pages 12 through 20 of the petition.

As a result of the contrary rulings of the Third Circuit and other circuits, the tax consequences of a transaction may depend on the judicial circuit in which the taxpayer resides. Respondent does not deny that this is an intolerable result.

Another anomaly of respondent's position is that a taxpayer can not know what the tax cnsequences of a transaction are -- or what to report on his tax return -- until the IRS exercises its claimed option to impose tax on the basis of form or on the basis of economic substance.

Nevertheless, respondent urges the Court to refuse certiorari on the theory that petitioners would have lost this case even if they had been permitted to look through the form to the substance. Respondent seeks to create the impression that this case is not a proper one for review by the Supreme Court because the Tax Court made a factual determination adverse to petitioners.

Respondent says that the Tax Court "reasoned that Atlantic [petitioner's assignor] did not possess any of the benefits and burdens of ownership of the computer equipment." Respondent adds in Footnote 3 of his brief: "*Danielson* also played no significant role in the outcome of *Coleman I*."

The opinion of the Tax Court is clear, however, that petitioners failed to carry their burden of proof as to ownership in *Coleman I* only because the Tax Court imposed on petitioners a much heavier burden of proof than is normal. The Tax Court did this based in large part on the *Danielson* decision of the Third Circuit.[1] The Tax Court said at 87 T.C. 202:

> We think it important to note that, in the instant case, it is the taxpayer and not the Government which seeks to disavow the form of the transaction...

[1]The petitioners had no forewarning that the Tax Court would rely on the Danielson case. The Tax Court did not refer to *Danielson* in the first decision in *Coleman I*, which the Tax Court withdrew. The second decision was, of course, rendered after the trial, when it was too late for petitioners to offer additional proof.

> Furthermore, the ability of a taxpayer to avoid the consequence of the form of a transaction is even more restricted in the Third Circuit Court of Appeals to which an appeal in this case would lie. *Sullivan v. United States, supra,* which extended the rule of *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), revg. and remanding 44 T.C. 549 (1965). Finally it is clear that the "strong proof" rule followed by this Court and the more restrictive rule of *Danielson,* apply beyond the confines of allocating payments to a covenant not to compete...

Moreover, in *Mukerji v. C.I.R.*, 87 T.C. 926 (1986), the Tax Court en banc distinguished *Coleman I* from a group of equipment leasing cases in which the taxpayers prevailed solely on the basis that in *Coleman I* the English lenders held title and this circumstance required the taxpayers to adduce "strong proof."

Respondents contentions that "neither the Tax Court's opinion nor the judgment order of the Court of Appeals even refers to the *Danielson* rule" and that "*Danielson* also played no significant role in the outcome of *Coleman I*" are simply wrong.

The Tax Court concluded at 87 T.C. 202:

> In light of the foregoing analysis, we conclude that the proper posture of this case is that the unconditional and consistently confirmed vesting of title in the lenders for a bona fide purpose creates a situation in which respondent has made a prima facie case that Atlantic was not the owner of the equipment for purposes of depreciation, and in which petitioners, claiming through Atlantic, should not be in a better position since, under the various agreements Majestic simply acquired Atlantic's interest in the equipment. In so concluding, we emphasize that we are not holding that Atlantic was not the owner of the equipment, but only that petitioners have the burden of producing, at a minimum, "strong proof" that the other elements of the burdens and benefits of ownership were such that Atlantic should be considered the owner and, additionally, that Majestic assumed such burdens and was entitled to such benefits of ownership with the result that it (and therefore petitioners) should be entitled to depreciate its (and their) investment in the equipment irrespective of any ownership by Atlantic. *Absent such "strong proof,"* petitioners must be held to have failed to carry their burden of proof as to the original deficiencies....(Emphasis added)

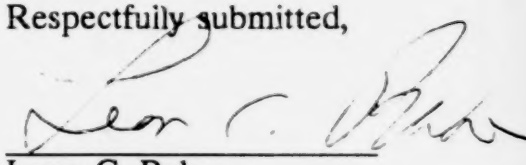
The degree of the burden of proof which a litigant is required to bear -- whether it is "preponderance of the evidence," "strong proof," "clear and convincing evidence," or "beyond a reasonable doubt" -- is a question of law. If, as is the case here, the Tax Court made a determination of fact by imposing the wrong burden of proof, that is an issue of law which can properly be reviewed by this Court.

## CONCLUSION

Whether the tax consequences of a transaction are to depend on form or on economic substance is an important issue in the administration of the Internal Revenue Code, and it is an issue on which there are irreconcilable conflicting views among the circuit courts of appeal. As is shown in the petition, the issue has significance not only with respect to equipment leasing but to a wide range of business arrangements, the taxation of which now depends on the circuit in which the taxpayer resides.

The conflicts among the circuits as to this important tax question should be resolved by this Court.

Respectfully submitted,



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